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UNCLAS SECTION 01 OF 02 OTTAWA 000385

SIPDIS

STATE FOR WHA/CAN - PATRICIA NORMAN, EB/TRA - SUSAN PARSONS

STATE PASS USTR FOR JOHN MELLE

USDOT FOR JEFF SHANE AND SUSAN MCDERMOTT

FAA FOR KRISTA BEREQUIST

TSA FOR SUSAN WILLIAMS

SIPDIS

E.O. 12958: N/A
TAGS: EAIR EINV CA
SUBJECT: Air Canada's financial woes may spur GOC to alter fees

1.(U) Portions of this message are Sensitive But Unclassified, please treat accordingly.

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Summary

¶2. (U) Air Canada's fourth quarter losses in 2002 are significant and have forced that airline to try to sell its maintenance, ground handling and commuter-feeder airline units. The federal government may reduce the air security fee from C$24 to C$18 to boost air travel, but there are few other options for federal cost cutting that can be passed on to the airline sector and traveling public. In the wake of global turbulence in the air travel sector, Air Canada and Canada's other airlines will have to adapt and restructure to the new market realities rather than rely on GOC maneuvering. However, restructuring may prove difficult unless the airline can attract foreign capital. End summary.

¶3. (U) After posting profits in the spring and summer of 2002, Air Canada, which accounts for more than 70 percent of all air passenger travel in Canada, took a beating in the last three months of 2002. The airline lost C$364 million dollars (US$239 million) in the period, compared to C$277 million dollars (US$182 million) in the period in 2001. To stem its losses, the company intends to: 1) sell stakes in its aircraft maintenance, ground handling and regional airline units; 2) seek changes in work rules and other concessions from its 36,000 employees, and 3) turn its cargo operation, employing 1,700 people, into a separate subsidiary.

¶4. (U) The troubles of Air Canada have led the Minister of Transportation, David Collennette to consider reducing the government imposed C$24 a ticket airline security fee and, or, reduce other fees such as navigation system charges and airport landing fees.

¶5. (SBU) According to Ministry of Finance officials the lowest the security fee could be reduced to, and still meet revenue needs given federally mandated aviation security expenditures, is C$18. An official with the Airline Pilots Association (ALPA) in Ottawa is confident that the fee will indeed be lowered, however, whether it will be reduced across the board or will be prorated on distance flown, is still up in the air.

¶6. (U) The Minister's expostulations on reducing Navigation fees and airport fees are much less certain. The entities that collect these fees and provide the corresponding services are private sector corporations that have not been under federal government management since the mid- to late-1990s. These non-share corporations cannot raise equity capital and must rely on fees and debt to finance their activities (and all surplus funds must be reinvested in the corporation). NAV Canada, which provides Canada's Air Navigation Services, was spun out of the federal government in 1996. It owns its infrastructure assets and sets its fees independent of the GOC.

¶7. (U) The federal government, however, remains the owner of Canada's major airports, although they are operated by independent local "Airport Authorities" (and the GOC is paid rent under sixty-year long lease arrangements). The airport authorities' fees and charges are not subject to review by the GOC. In particular Airport Improvement Fees (AIF) provide an attractive revenue source since passengers are largely captive. All major Canadian airports have either introduced AIFs or are in the process of doing so. Thus the GOC cannot simply force the airport authorities or NAV

Canada to reduce fees - and unless the GOC provides operating subsidies to these entities to make up for any lost revenue there would be no incentive for them to do so. In a best case scenario the GOC would have only the option of reducing the rent it takes from the airport authorities and hope that the airports would pass the savings along to air travelers, perhaps by reducing AIFs.

Comment

¶8. (SBU) At this juncture the conventional wisdom among airline industry observers is that the GOC is very unlikely to engage in direct subsidies of NAV Canada and the airports to save money for the airlines. An overt bailout of Air Canada, of the type seen in the United States post 9-11 is also not on the table. The big losses posted by Air Canada this past quarter now places all of North America's "full service" carriers in the same tough financial straits but, despite the serious crisis in the industry, Minister Collenette's only real option is to reduce the security fee. Indeed, Collenette has inferred there is little the government can do in the face of a global decline in air travel in the wake of 9-11 - and it will be up to Air Canada to continue to adapt and restructure to become profitable under the new market conditions. After all, the "low-cost" model airlines (e.g. Southwest, Jet Blue, and Canada's WestJet) are managing to make money. Embassy doubts whether Air Canada will be able to raise enough cash by selling assets to Canadian entities; a significant investment of foreign capital in the Canadian aviation industry will be vital to Air Canada's long-term health. However, given the current state of the industry, it is not clear where that capital will be found.

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